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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	CC Docket No. 94-1
Price Cap Performance Review	)	
for Local Exchange Carriers	)	

COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

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May 9, 1994

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BellSouth Telecommunications, Inc. ("BellSouth"), by and through its undersigned attorneys, hereby submits the following Comments in the above-captioned matter.

I. OVERVIEW & EXECUTIVE SUMMARY

A. Overview: Regulatory Flexibility and the Logic of Price Caps

In the wake of dramatic changes in telecommunications technology and markets that have occurred in recent years, a shared priority of the Clinton Administration, the Congress and the Commission has been to promote the rapid development and deployment of a National Information Infrastructure ("NII"). The NII is to be accompanied by a new, flexible telecommunications regulatory regime that will "facilitate greater economic growth by removing regulatory barriers" and "create new jobs, new business opportunities and expanded diversity of choice for American consumers."[1/] Four years ago, the Commission anticipated this visionary move towards telecommunications regulatory

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1/ The Administration has called for a "new approach" to telecommunications policy:

> Even if the lines between industries and markets were clear in the past, technological and market changes are blurring and erasing them. Regulatory policies that are based on such perceived distinctions can harm consumers by impeding competition and discouraging private investment. In light of these realities, the Administration is committed to removing unnecessary and artificial barriers to participation by private firms in all communications markets, while making sure that customers remain protected.

Administration White Paper on Telecommunications Reform at 1 (1994) (emphasis added).

reform by fundamentally redefining the method by which AT&T and the largest local exchange carriers ("LECs") are regulated.[2] Specifically, the Commission took major steps to replace most of its traditional rate-of-return or "cost-plus" system of regulation with the incentive-based system of price caps. Now, recognizing that the "potential contribution of telecommunications to our society has never been greater,"[3] the Commission has instituted this timely review of its LEC price caps plan, and has solicited comprehensive comment on whether and how the price cap system might be revised to better serve the goals of the Communications Act and the public interest in the years ahead.

The following Comments are framed around BellSouth's overall conclusion that the Commission's LEC price cap plan to date has been an important first step -- but only a **qualified** success -- in promoting the regulatory vision that will truly maximize LEC contributions to economic growth, infrastructure development and the creation of jobs for American workers. The economic experience and performance of the large LECs in general and of BellSouth in particular under the Commission's price cap regime support the Commission's basic policy judgment, articulated in the LEC Price Cap Order, that "a properly-designed system of incentive regulation" is superior to a rate-of-return-based regime

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2/ The Commission considered the adoption of price cap regulation for AT&T and the largest local exchange carriers in a single docket, CC Docket No. 87-313. See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987); Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988); Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873(1989) ("AT&T Price Cap Order"), modified on recon., 6 FCC Rcd 665 (1990) ("AT&T Reconsideration Order"); 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order"), Erratum 5 FCC Rcd 7664 (1990), modified on recon., 6 FCC Rcd 2637 (1991) ("LEC Reconsideration Order"), aff'd, National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). There were two primary differences in the initial price cap plans adopted for AT&T and the LECs: 1) the LECs were assigned a higher productivity offset than AT&T; and 2) the LEC price cap plan included a rate-of-return-based sharing mechanism, while the AT&T price cap plan did not. As discussed infra, as a result of this latter difference, the two plans evolved very differently during the initial three years of price cap regulation.

3/ In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Notice of Proposed Rulemaking (released Feb. 16, 1994), at 2, ¶ 3 ("Notice").

and generates greater consumer benefits.[4] Nevertheless, BellSouth also believes strongly that the Commission's current regulatory structure -- which is not yet a "pure" price cap plan but an interim hybrid of direct price and rate-of-return regulation -- can and must be modified in several important ways if the public interest goals of price cap regulation, including the deployment of the NII, are to be fully realized. In later sections of these Comments, BellSouth presents specific data that confirm the generally positive effect of the current plan on BellSouth's performance, but which also suggest room for improvement. Price cap regulation has yielded lower rates to consumers. At the same time, BellSouth has made significant investment in its network and deployed new technologies, and has introduced innovative new services to its customers. To this extent, the Commission's price cap plan has proven successful. BellSouth believes, however, that there are important modifications that can vastly improve the plan's overall performance, and thus stimulate far greater benefits. Moreover, these modifications are essential in light of the rapidly emerging competition in the LEC industry.

The general objective of price cap regulation is to harness the profit-making incentives common to all businesses in order to produce a set of outcomes that ultimately advance the public interest goals of guaranteeing just, reasonable and non-discriminatory rates to consumers, as well as the development of a telecommunications infrastructure that offers innovative, high quality services.[5] Implicit in the "logic" underlying price cap regulation are four interlocking, fundamental premises. These are that: (1) changes in the form of regulation and imposition of regulatory constraints can fundamentally affect a large LEC's incentive structure and ability to respond in the marketplace; (2) changes in the LEC's incentive structure and permissible market conduct in turn affect the carrier's behavior in the

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4/ LEC Price Cap Order, 5 FCC Rcd at 6789.

5/ Id. at 6787, ¶ 2.

telecommunications market; (3) market conduct of the LECs affects the overall performance of the telecommunications market; and (4) telecommunications market performance ultimately affects macroeconomic performance, job creation and infrastructure development.[6]

In following the logic of price caps, the Commission has acknowledged the tremendous advantages of using incentive-based regulation rather than traditional rate-of-return mechanisms to achieve its public policy goals, especially in view of the radical changes that have occurred and continue to occur in the years following the AT&T divestiture.[7] Incentive regulation "replicates more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market."[8] By "capping" the overall prices that a carrier may charge for its services, the Commission ensures that the carrier's primary means of increasing earnings are to become more efficient and to innovate in the provision of services. Price cap regulation thus breaks the direct link between prices and earnings and curtails the perverse incentives that historically have

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6/ Thus, in adopting the LEC Price Cap Order, the Commission reasoned:

> The companies we seek to regulate under an incentive-based system are large, publicly-traded firms, that compete daily for sales of nonregulated products and services, in the financial markets, and in the labor markets. If we can design a regulatory system for these carriers' access business that mirrors the efficiency incentives found in competitive markets, we will have put in place a system that will go a long way toward making the LECs stronger, more productive competitors for all of the markets in which they must operate. The result will be an even healthier, more vital sector of the U.S. economy, and lower rates for consumers.

Id. at 6790, ¶ 33.

7/ In the LEC Price Cap Order, the Commission observed that the basic rate-of-return mechanisms that form the foundation of its rate-of-return regulatory system were originally designed for the regulation of public utilities decades ago. The Commission moved to a price cap mechanism because it was concerned that "the system of regulation we currently employ does not serve to sharpen the competitiveness of this important segment of the industry at a time when telecommunications goods and services are becoming increasingly competitive, both nationally and internationally." LEC Price Cap Order, 5 FCC Rcd at 6790; see also Strategic Policy Research, "Regulatory Reform for the Information Age" (Jan. 11, 1994), at 1 ("SPR Vision Paper") (observing that state and federal regulators have recognized in recent years that "traditional rate-of return (RoR) regulation is wholly inappropriate for the telecommunications industry").

8/ AT&T Price Cap Order, 4 FCC Rcd at 2893.

attended rate of return regulation.[9/] Price regulation also advances the public interest by affording consumers strong protection against monopoly pricing by establishing maximum aggregate prices for groups of services, but at the same time allowing carriers the flexibility to adjust prices easily as long as prices remain at or below the overall cap -- an essential element for the development of true price competition.[10/]

The superiority of a "pure" price cap regime over a rate of return-based system in combining lower rates with effective incentives for improved efficiency and innovative services has been confirmed by the Commission's recent four-year performance review of AT&T.[11/] Unfortunately, the Commission's price cap plan for LECs is not yet a "pure" incentive-based system. The Commission decided that in its initial stage of implementation of LEC price caps, it would take a more "cautious and careful" approach with the LECs than with AT&T.[12/] Accordingly, the Commission grafted additional regulatory pricing restrictions to the LEC price cap plan that run counter to the basic principles of incentive-based regulation and to the internal logic of price caps. Chief among these restrictions was an earnings sharing mechanism intended to provide a "backstop"

9/ Under a pure price caps system -- unlike rate-of-return regulation -- cost padding and cross-subsidization do not justify higher prices. Instead, such behavior actively decreases carrier profits, and there is therefore no incentive to engage in it. See AT&T Price Caps Order at 2893, ¶ 36; see also LEC Price Cap Order, 5 FCC Rcd at 6790-91.

10/ Other significant advantages of price caps include reduced administrative cost and complexity and more effective policing of shifting industry boundaries. AT&T Price Cap Order at 2893, ¶¶ 36-37. These advantages again flow from the fact that cost allocation requirements do not play the central role under price cap regulation that they do under rate-of-return regulation. The restraints on price increases become less significant when competition develops because competitive forces hold prices down.

11/ Specifically, the Commission's review of AT&T's performance during the first four years of price cap regulation "largely confirm[ed] our expectations for price caps: that it represents an improvement over rate of return regulation, combining lower rates with effective incentives for improved efficiency and innovative services." In the Matter of Price Cap Performance Review For AT&T, 8 FCC Rcd 6968 (1993), at ¶ 1. The Commission found that under price caps, long distance rates paid by AT&T's residential customers fell by 5.3%, despite overall inflation in the American economy of 16.1%. Id. The Commission also noted that during this period, AT&T's earnings have risen and its infrastructure has improved, notably in technological sophistication. Id. at 6969, ¶¶ 10, 12.

12/ LEC Price Cap Order, 5 FCC Rcd 6787, ¶ 4.

measure of protection against excessively high or low earnings. This "sharing" mechanism once again ties prices to costs by retaining the central concept of rate of return regulation, i.e., by looking to overall earnings on a rate base to measure LEC productivity and performance.[13/] In the process, it largely destroys the incentive structure that price cap regulation was designed to provide.[14/]

The Commission has now gained both perspective on and historical experience with LEC price cap regulation. As it stands ready in this proceeding to "refine" the goals of its price cap regime to account for the convergence of telecommunications markets and services and the exponential enlargement of the capabilities of telecommunications networks, it is imperative that the Commission remove unnecessary regulatory restrictions that blunt or actively undercut the basic objectives and incentives of price regulation.

Furthermore, increased regulatory and earnings flexibility in the Commission's price cap plan -- as the Commission has broadly recognized -- is essential if the promise of the NII is to be achieved. BellSouth strongly believes that the NII will be built because it is good business to do so. The vast variety of new services that will be offered clearly will stimulate the economy and American productivity. However, the speed and efficiency with which such changes will be made is critically dependent on the regulatory structure and

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13/ See id. at 6801, ¶ 121. The Commission also imposed service category banding limits, which restrict LEC pricing flexibility, and a demand adjustment component for Carrier Common Line.

14/ As Professor Robert Harris observes, price cap regulation with earnings sharing is actually a variant of traditional rate of return regulation which, by design, limits the incentives for efficiency, innovation: and good performance. See Robert G. Harris, "The Economic Benefits of LEC Price Cap Reform," in Support of the United States Telephone Association, CC Docket No. 94-1 (May 9, 1994), at 20 ("Harris Report"). Professor Harris also notes three other flaws in earnings sharing: (1) earnings sharing with low-end adjustments leaves customers at risk, since they "share" in any under-earnings of the regulated firm; (2) sharing plans are costly and complex to administer, because they require both an apparatus for price indexing and an apparatus for measuring and regulating rate of return; and (3) with the death of the franchise "monopoly," i.e., because of the rate of emerging competition, regulators are no longer in a position to honor their "social contract" with regulated firms to ensure the recovery of, and return on, private capital over its useful life. Id. at 19-20.

incentives promulgated by the Commission. BellSouth asks only that the Commission **allow price caps to work** by completing its transition from rate of return/earnings regulation to a market-driven system that is demonstrably superior in achieving the Commission's public interest goals, including the investment in the new services and technologies that will help comprise the Information Superhighway.[15/]

BellSouth's Comments below track the specific issues raised in the Notice. Many of BellSouth's specific proposals flow from certain simple principles which require modification of the Commission's current plan. These basic principles include:

- **Eliminate once and for all the link between prices and earnings**

As Commissioner Barrett has observed, it is time for the Commission to eliminate the vestiges of rate of return regulation that maintain perverse efficiency incentives and discourage infrastructure investment.[16/] The Commission should remove sharing and the lower formula adjustment mechanisms from the LEC price cap plan and move LECs to a system of "pure" price caps that provides better incentives for efficiency and infrastructure investment. Similarly, in examining the productivity factor component of the price cap index, the Commission must not undercut the profitability incentives that generate increased

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15/ More precisely, as the Notice acknowledges, the incentive system of price caps is fundamentally based upon and driven by profitability. Notice at 20, ¶ 45. In terms of infrastructure buildout, it is plain that investment follows opportunity, and that LECs generally are obligated to their shareholders to invest in those business opportunities where expected returns are greatest in light of associated risks. Thus, if LEC earnings are limited in certain areas of their businesses, as they are for price cap services by the current sharing mechanism, LECs consequently will seek out other investment opportunities in less regulated lines of business where potential returns are greater, or invest internationally in less restrictive regulatory environments. See Harris Report at 1 (observing that "[p]rivate investors -- including LEC shareholders -- will not risk their savings unless they are assured that the potential rewards are worth the risk: the government should not expect that wishing for private investment will make it happen"). Adoption of a purer form of price regulation, i.e., one stripped of rate-of-return vestiges like the sharing mechanism, will go far towards creating even more powerful incentives to invest in the nation's information infrastructure.

16/ Commissioner Andrew C. Barrett, Federal Communications Commission, Beyond Price Caps: Escaping the Traditional Regulatory Framework (Aug. 27, 1992), at 7 ("Specifically, it's time to sever the link we have forged between prices and earnings on a rate base and let the market regulate those prices that it can. And it's time to further streamline the process of regulation so it can cope with the new technologies and industry structure.").

efficiency and productivity by focusing inappropriately on increased earnings levels that should be anticipated to occur under such a system.

- **Increase LEC pricing flexibility**

Under price caps, services that have not been transitioned to streamlined regulation remain subject to an overall pricing constraint. The baskets and bands that are features of the Commission's hybrid plan are methods of further restricting the degree of pricing flexibility that would otherwise obtain under a theoretically pure price cap system. While the Commission may wish to preserve a basket and banding structure to continue some basic limits on LEC pricing flexibility, the structure in its current form, with numerous service categories and subindices, is far more restrictive than is necessary to ensure reasonable prices. The Commission should focus on eliminating those price cap constraints that serve no legitimate regulatory purpose and which needlessly interfere with the efficiencies and incentives that price caps are intended to create.

- **Continue to promote and facilitate the transition to streamlined regulation**

The Commission should establish <u>now</u> the ground rules for streamlining the regulation of LEC services as competition develops and market forces are able to replace regulation as the controlling factor in limiting the market power of any one firm and in ensuring just and reasonable rates. Here, the Commission should not focus on market share as the measure for regulatory relief, but instead should look to the reduction or absence of barriers to entry as the trigger for considering streamlined regulation in specific markets. By establishing the ground rules now and adopting a forward-looking regulatory structure, the Commission will send the correct signals to the LECs and to the marketplace in general. A visionary regulatory plan will help guarantee the development of the NII.

B. Executive Summary

The Notice has presented twelve general "Baseline" categories for comment regarding potential changes to its core LEC price cap regulatory regime, and six "Transition" issues for comment relating to the adaptation of the LEC price cap plan in response to competitive market developments. In response to the Commission's baseline issues, BellSouth recommends specific, affirmative changes to the price cap rules that will significantly improve the performance of the overall LEC plan. These baseline changes include:

(1) **Elimination of sharing and low end adjustment mechanisms** --

BellSouth believes that it is imperative for the Commission to eliminate the sharing and low-end adjustment mechanisms. These devices are interim safeguards that were never intended to be long-term features of the LEC price cap plan, are no longer warranted, and perpetuate administrative complexity and perverse rate of return incentives that are fundamentally incompatible with price regulation. Moreover, the Commission now has had significant experience with price cap regulation of both the LECs and AT&T, and the empirical data gathered over the first three years of price cap regulation contain no extraordinary or unexpected scenarios that justify continued administrative and regulatory impediments to the functioning of a pure price cap system. The elimination of these unnecessary devices will also eliminate regulatory roadblocks in other proceedings, and permit the Commission to refocus its attention and resources upon much needed regulatory reform in other related areas, such as depreciation reform.

(2) **Lowering of the Productivity Offset** --

A recent Total Factor Productivity (TFP) study performed by Christensen Associates on behalf of the United States Telephone Association suggests that the baseline productivity offset for price cap LECs initially chosen by the Commission in fact has proven to be too high. Measuring from the time of the AT&T divesture (1984) through the first two years of price caps (1992), the Christensen study calculates that the growth differential between the LECs and the most comprehensive TFP measure published by the Bureau of Labor Statistics has been **1.7 percent**. Even adding in the 0.5 percent Consumer Productivity Dividend ("CPD"), the Christensen result suggests that the LEC productivity offset should be reduced over a full percentage point from the Commission's 1990 estimate. The appropriateness of a reduction in the LEC productivity offset is further reinforced by the likelihood that the aggregate productivity growth of the price cap LECs in the coming years will be slower than the historical industry average reflected in the current price cap plan as competition continues to emerge rapidly in the local exchange market.

(3) **Modification of rules governing the introduction of new services --**

BellSouth urges the Commission to reform the detailed cost and engineering support requirements associated with the introduction of new services in order to encourage price cap LECs to develop and introduce innovative new services. In addition, BellSouth urges the Commission to amend its Part 69 rules to remove the rate structure requirements associated with switching and common line elements, at least to the extent that LECs are permitted to create new service elements and to repackage existing elements with new elements provided that existing services continue to be offered under the current structure.

(4) **Revision of the LEC price cap basket and banding structure --**

Building upon the recent changes in the basket structure adopted by the Commission in connection with its restructuring of local transport rates, BellSouth proposes to eliminate those price cap constraints which serve no legitimate regulatory purpose, but instead only interfere with the efficiencies and incentives that price caps are intended to create. BellSouth proposes no change to the basket composition for the common line, traffic sensitive or trunking baskets, but recommends that the interexchange basket be redesignated as "Other." BellSouth also suggests limited modifications to the service categories in the trunking and traffic sensitive baskets, including elimination of subindices for DS1 and DS3 services, as well as increased downward pricing flexibility. These focused changes represent efficiency and incentive improvements that can be achieved without ceding any appropriate regulatory interests of the price cap plan.

BellSouth believes that its proposed baseline modifications to the price cap rules are necessary to improve the performance of the LEC plan and will ensure that the plan continues to achieve the Commission's expansive public policy objectives. BellSouth requests that the Commission afford baseline price cap changes the highest priority, and implement them no later than January 1, 1995.

In view of the dramatic changes taking place in telecommunications technology and markets, the LEC price cap plan also must be modified and positioned to accommodate rapidly emerging competition in the local exchange marketplace. In response to the transition issues presented in the Notice, BellSouth provides specific and detailed data on competition in BellSouth service areas, and proposes a transition framework which relaxes regulation commensurate with the presence of competition. Supported by the analysis of Dr. John Haring and Dr. Jeffrey Rohlfs of Strategic Policy Research, this framework will lead to streamlined regulation for access services subject to effective competition.[17/] BellSouth urges the Commission to look to a measure of the deployment of productive capacity -- as opposed to a measure of market share -- as proof of the reality of competition in particular markets that would trigger the implementation of streamlined regulation for particular services. Once again, given the current, rapid growth of competition in the local exchange marketplace, BellSouth believes that it is imperative for this framework to be adopted and implemented on an expedited basis.

BellSouth believes that its proposed changes to the LEC price cap plan are necessary preconditions to harnessing the explosive potential of modern telecommunications. They will have positive, beneficial effects on job creation, economic growth and universal access to the NII for all Americans.

II. GENERAL ISSUES

In addressing overall policy goals and possible new directions for regulation of the LECs, the Commission has requested comment on the continuing validity of the goals of its price cap plan, and the effect of the price cap plan on consumer welfare, the economy and job creation.

In order to effectuate the general public interest goals of the Communications Act, i.e., assuring just, reasonable and non-discriminatory rates and promoting a communications system that offers innovative, high quality services, the specific goal of price cap regulation is to replicate the effects of a competitive market in order to encourage firms

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17/ John Haring and Jeffrey H. Rohlfs, Strategic Policy Research, Comments on Transition Issues, (April 19, 1994) ("Haring/Rohlfs Report"). This report is attached hereto as Attachment 1.

to make economic decisions. By rewarding companies for becoming more productive, the price cap plan is designed to encourage firms to modernize their networks, deploy new technologies, and offer new services.[18/]

The Commission has expressed its belief that the existing public policy goals of price caps remain valid. BellSouth agrees that these goals are not only valid but essential to our country's continued economic growth and leadership in the Information Age.[19/] With respect to potential broadening of price cap objectives, BellSouth believes that such goals could be expanded to explicitly include:

- **Promotion of job creation and stimulation of macroeconomic growth**;
- **Promotion and buildout of the NII** through the implementation of proper investment incentives, regulatory and pricing flexibility;
- **Promotion of universal service**, i.e., encouraging the wide-spread availability of modern telecommunications services at reasonable rates;
- **Stimulation of new service development** via the removal of regulatory impediments;

18/ Notice at 12, ¶ 31. Thus, consumers benefit from the lower rates generated by capped prices, as well as the increasing productivity and lower costs of the LECs. The national economy also benefits because lower telecommunications prices help lower the prices of the many goods and services that use telecommunications in their businesses, and from the increased jobs and domestic economic growth generated from increased sales in international and domestic markets. LECs in turn benefit from the heightened demand for services resulting from lower rate levels under price cap regulation. Thus, the ultimate goal of price caps is to promote economic growth and to stimulate "an even healthier, more vital sector of the U.S. economy." Id. (citing LEC Price Cap Order, 5 FCC Rcd at 6790-91).

19/ As Haring and Rohlfs observe:

> LEC price caps matter, in particular, in terms of the extent to which the United States will possess an economically efficient telecommunications infrastructure as the millennium approaches. Indeed, we are hard-pressed to think of any other single regulatory proceeding (before the Commission) that is as significant as LEC price caps when it comes to efficient deployment of advanced communications technologies and maintenance of a policy framework conducive to efficient competition.

Haring/Rohlfs Report at 1-2 (emphasis in original). Haring and Rohlfs further note that price caps not only provide a potentially powerful means for strengthening incentives to invest and deploy new technological capabilities, but also supply a highly credible safeguard against anticompetitive cross-subsidization. See id. n.3.

- **Promotion of balanced competition in access markets** through recognition of the rapid changes affecting the LEC industry and implementation of proper transition mechanisms to streamlined regulation; and

- **Promotion of a flexible regulatory regime and minimization of regulatory burdens**, which helps to achieve all of the above goals in a manner that also promotes administrative efficiency and conserves Commission resources.

What is obvious from these "expanded" goals is that they are straightforward extensions of the principles that are already fundamental components of price cap theory. As the Commission pursues its comprehensive review of the LEC price cap plan, BellSouth believes there are changes that the Commission can and should make to the plan that will serve all of the policy goals of price caps more effectively.

Specific changes to the Commission's price cap plan have been outlined above and are presented below in connection with particular baseline and transition issues upon which the Commission has requested comment. In general, however, these changes are grounded in BellSouth's proposal for the Commission to move LECs to a "pure" price caps plan that maximizes efficiency incentives, gives LECs greater pricing flexibility and breaks the residual link between prices and earnings contained in the current LEC price cap plan.

In addition, BellSouth has reviewed the submission of the United States Telephone Association (USTA), also filed today. The USTA filing contains a number of important studies which support both USTA's and BellSouth's conclusions and proposals with respect to price cap reform. These include:

- The Economic Benefits of LEC Price Cap Reform, by Robert G. Harris -- Professor Harris explains why growing competition in access service dictates changes in price caps; identifies the goals and principles for reforming price caps; and provides the economic rationale for proposed reforms and the benefits of those reforms to users and providers of access services.

- <u>Comments on the USTA Pricing Flexibility Proposal</u>, by Richard Schmalensee and William Taylor ("Schmalensee and Taylor Comments") -- This report explains why increased pricing flexibility for LECs would promote balanced competition in access services and enable LECs to better respond to customers' individual needs by charging prices that more accurately reflect costs of providing services.
- <u>Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation</u>, by Laurits R. Christensen, Philip Schoeth and Mark E. Meitzen ("Christensen Productivity Study") -- This study reports the results of a Total Factor Productivity (TFP) study of price cap LECs, which found that the average annual difference between the productivity growth of the LECs and the US economy has been 1.7%.
- <u>Economic Performance of the LEC Price Cap Plan</u>, by National Economic Research Associates, Inc. (NERA) ("NERA Study") -- NERA analyzes how the major components of the price cap index formula, inflation and the productivity offset, have worked and explains why a reduction in the current offset is supported by long-term TFP results and would improve the incentives of price cap regulation.
- <u>Price Cap Reform, Financial Incentives and LEC Investment</u>, by Larry Darby ("Darby Report") -- This report focuses on the impact that regulation has on the level of LEC investment in the public network. The report concludes that the price cap modifications would likely stimulate LEC investment in the public network by five percent in the first year to a fifteen percent increase over the next ten years.

- <u>Accelerating Investment in the Telecommunications Network -- Impacts on Technology Adoption and Service Quality</u>, by Lawrence K. Vanston, Technology Futures, Inc. ("Vanston Report") -- This report focuses on the acceleration of technology if investment was increased. The report concludes, based on the stimulation of investment predicted by Dr. Darby, that new digital services will become widely available and adopted one to two years earlier than they otherwise would be. The earlier adoption in turn will result in an initial one percent annual increase in telecommunications quality of services increasing to a three percent annual increase by 2004.
- <u>The Economic Impact of Revising the Interstate Price Cap Formula for the LECs</u>, by the WEFA Group ("WEFA Study") --WEFA reports the results of macroeconomic modelling of the benefits of the USTA proposal for revising the interstate price cap formula over the next ten years: an additional 510,000 jobs; $47.9 billion increase in Gross Domestic Product in 2004; consumers save $65 billion in real terms through lower inflation; and disposable income $23 billion higher in real terms in 2004.

Through USTA, BellSouth has supported these studies and reports. They demonstrate the significant macroeconomic benefits -- in terms of economic stimulus, job creation and consumer welfare -- that will flow from price cap reform.

III. BASELINE ISSUES

Baseline Issue 1: Infrastructure Development

Baseline Issue 1a:

Whether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure.

Baseline Issue 1c:

We request that interested parties submit data and analysis regarding the rate at which price cap LECs are replacing copper wire with fiber optic cable and increasing the bandwidth capacity of copper wires with signal compression techniques and other techniques.

By mandate of the Communications Act, a core purpose of the Commission that dovetails exactly with NII and universal service initiatives is to "make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges."[20/] The Notice acknowledges the vital role that the price cap LECs will play in establishing the conditions for the implementation of the NII, and it is therefore timely for the Commission to re-assess the effect of the current LEC price cap plan on the development and deployment of an advanced telecommunications infrastructure.

In the LEC Price Cap Order the Commission stated its belief that price caps would provide LECs with sufficient incentives to expand network investment in advance of demand, and that the Commission's continuing support of the development of competition through price cap regulation would "provide LECs with the opportunity to continue their efforts to modernize the communications infrastructure and to maintain a level of investment which will lead to the implementation of an intelligent, interconnectable, broadband

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20/ 47 U.S.C. § 151.

network."[21] BellSouth believes this statement to be theoretically true and confirmed by LEC experience under the price cap plan.

A significant degree of modernization of the LEC network has occurred to date under price caps. Over the past three years, the eight largest LECs have invested approximately $50 billion in new plant and equipment -- which includes $8.9 billion of BellSouth investment -- and have exhibited a significant, steady progression in upgrading switching equipment, laying fiber optic cable, upgrading the capacity of their copper plant, implementing new services and technologies, and extending service to non-urban areas.[22] From 1989 to 1993, BellSouth alone has invested almost $15 billion in new plant and equipment in its network, with $8.9 billion spent in the 1991-93 price cap period. From 1991 to 1993, BellSouth has added approximately 511,000 fiber miles in its territories for a total of over 1.1 million miles; increased the percentage of access lines served by digital switches from 51% to 69%; increased the percentage of access lines equipped for Common Channel Signaling System 7 (SS7) from 59% to 93%; and increased the percentage of access lines equipped for Basic Integrated Services Digital Network (ISDN) from 7% to 39%.[23] In short, the Commission's confidence in 1990 that price cap LECs would not seek to cannibalize their networks in the search for short-term profits has been vindicated.[24] LECs have continued to upgrade their networks, invest in and deploy new technologies like ISDN and SS7, and have invested in new services.

21/ LEC Price Cap Order, 5 FCC Rcd at 6830, ¶ 355.

22/ See Notice at 10-11, ¶ 29.

23/ Illustrative charts summarizing BellSouth-specific infrastructure data are included at the end of BellSouth's response to this baseline issue.

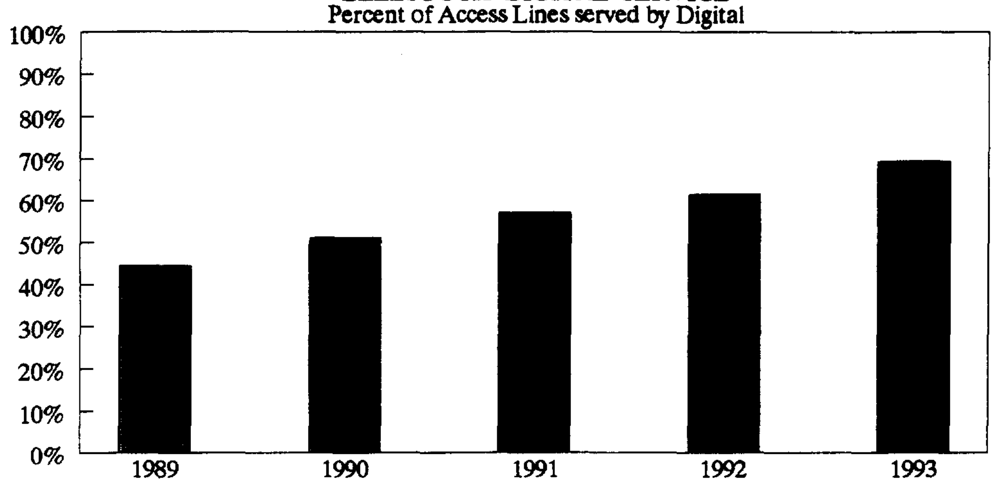
24/ See LEC Price Cap Order, 5 FCC Rcd at 6827, ¶ 335.

This positive progression in infrastructure development, however, is relative to the success that can be achieved by modifying the current hybrid price cap plan to be more consistent with the theoretical underpinnings of price regulation. LECs have limited resources available for new technology and new service investment, and it is axiomatic that investment follows opportunity. In evaluating whether and how to invest, LECs are motivated -- and indeed, obligated to their shareholders -- to pursue those investments that will reap the greatest expected returns in light of associated risk. Although "pure" price regulation theoretically seeks to emulate competitive markets, the Commission's hybrid plan continues to impose complex and costly regulatory constraints on LEC earnings that provide far less incentive for LECs to re-invest in price cap services relative to other, less regulated lines of business that offer the potential for greater returns.[25]

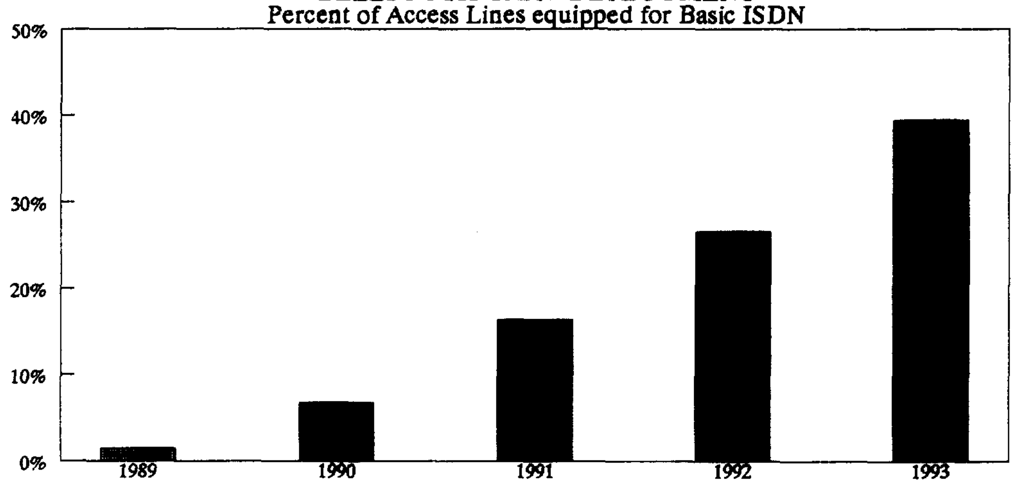
In connection with other baseline issues discussed below, BellSouth proposes revisions to the LEC price cap plan that will facilitate BellSouth and other price cap LECs' individual and collective abilities to invest in new technology and infrastructure by permitting them to respond more readily to market demand. Moving to a "pure" price cap regime is the surest and best way for the Commission to maximize LEC participation in the buildout of the NII.

25/ Sharing mechanisms in particular dull efficiency incentives and suppress efficiency gains. SPR estimates that a 4-year hybrid price cap plan with 50/50 sharing has only approximately 18 percent of the efficiency incentives provided in unregulated competitive markets. SPR Vision Paper at 22.

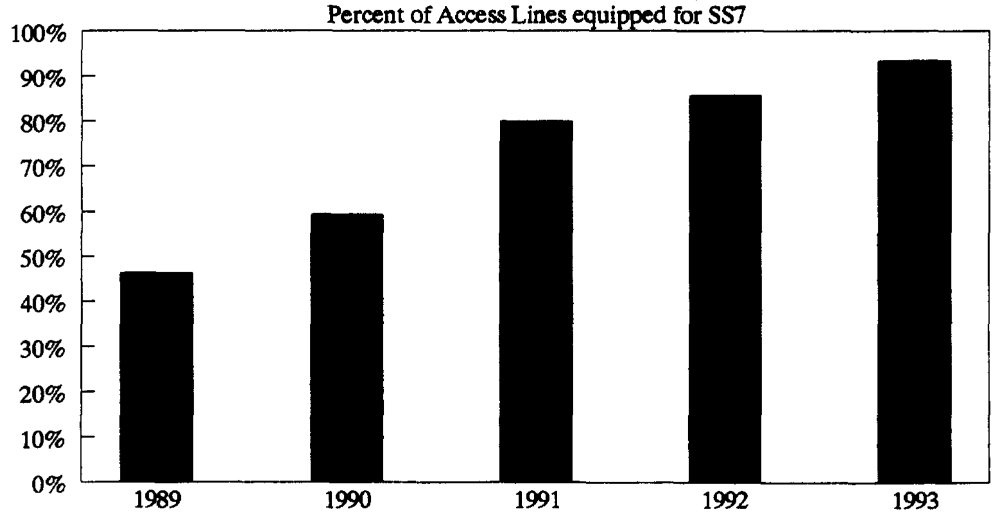
BELLSOUTH DIGITAL SERVICE
Percent of Access Lines served by Digital



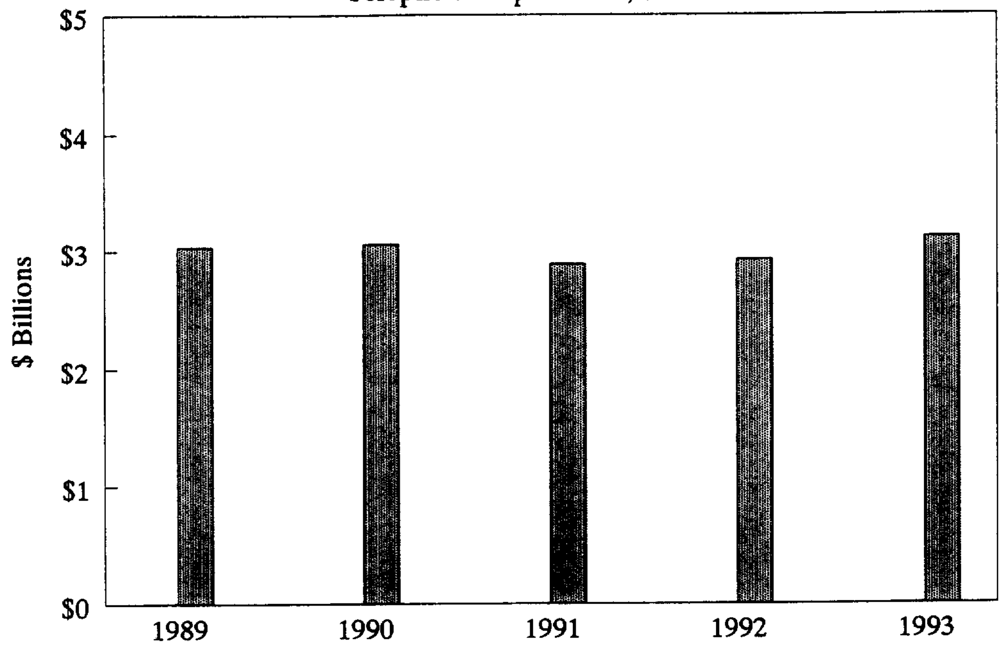
BELLSOUTH ISDN DEPLOYMENT
Percent of Access Lines equipped for Basic ISDN



BELLSOUTH COMMON CHANNEL SIGNALING SYSTEM 7
Percent of Access Lines equipped for SS7

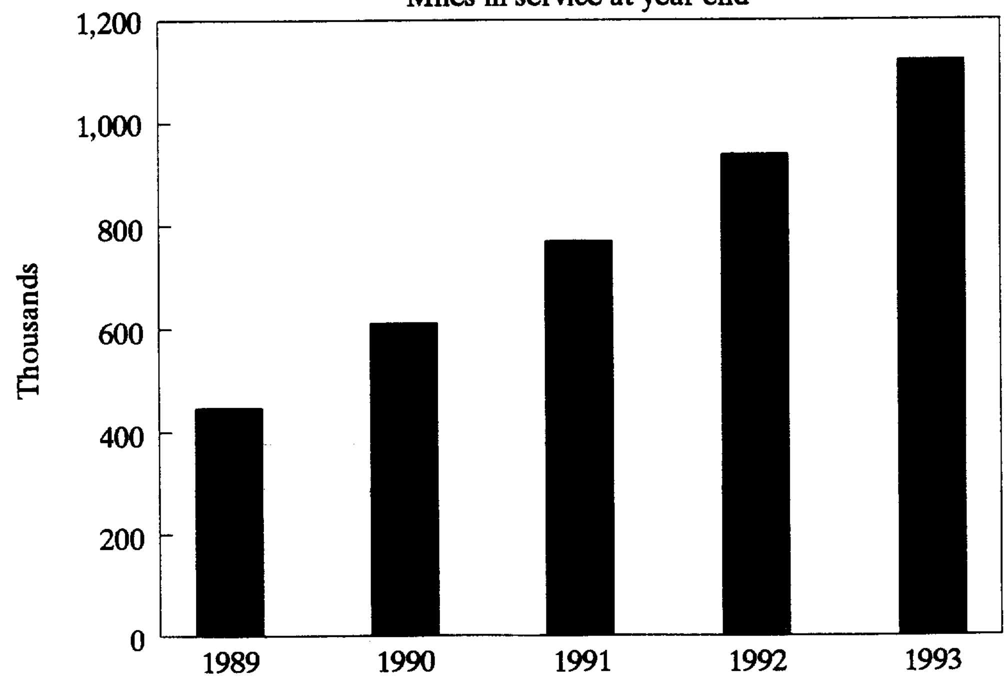


BELLSOUTH ANNUAL CONSTRUCTION EXPENDITURES
Telephone Operations, $ Billions



Includes gross additions to property, plant and equipment with service life of one year or more, new capital lease assets, gross additions to operating lease equipment and reused materials.

BELLSOUTH FIBER MILES
Miles in service at year end



Baseline Issue 1b:

> *Whether the goal of providing universal service to all geographic areas and of equal type and quality for all Americans at affordable prices is being met, or whether we should revise the LEC price cap plan to ensure the provision of universal service.*

BellSouth believes that significant progress has been made in meeting the Commission's goal of providing universal service to all geographic areas and of equal type and quality for all Americans.[26/] Currently, over 94% of all Americans have basic telephone service.[27/] While it is true that citizens in the lowest income brackets have telephone penetration levels that lag behind the national average, even these penetration levels have generally improved over the last decade. In addition, various programs have been instituted by BellSouth and other LECs to preserve and promote universal service.[28/]

With regard to possible revisions to the price cap plan that can further ensure the provision of universal service, BellSouth again urges the Commission to adopt a pure price caps regime. Pure price regulation is designed to emulate as closely as possible the incentive structure of a market economy, thereby encouraging carriers to profit through increased penetration, increased operational efficiency and the introduction of innovative new services. Thus, the incentives that comprise the core of price cap regulation also further the

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26/ See Statement of Reed E. Hundt, Chairman, Federal Communications Commission, before the Committee on Commerce, Science and Transportation, United States Senate, on S. 1822, the "Communications Act of 1994" and "Telecommunications Equipment Research and Manufacturing Competition Act of 1994" (Feb. 23, 1994), at 2 (reaffirming "our national commitment to universal service in order to ensure that all Americans can participate in the information economy").

27/ Federal Communications Commission, Common Carrier Bureau, Telephone Subscribership in the United States (March 1994), at 6.

28/ For example, the Link-up America Program is in place in all nine states that comprise the BellSouth region. In addition, programs such as Lifeline which waive the monthly subscriber line charge are in place in Mississippi, North Carolina, Georgia and Tennessee. A Lifeline program will commence in Florida on July 1, 1994. These programs are targeted to individuals/families below the poverty level. Nationwide, the Lifeline programs have resulted in millions of low-income Americans being able to have telephone service that otherwise might not be affordable to them. BellSouth has worked with and will work with commissions in its region that have not instituted the Lifeline program to convince them of the need for such measures.